

PINNACLE BANK
Morgan Hill, California

FINANCIAL STATEMENTS
December 31, 2018 and 2017

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INDEPENDENT AUDITOR'S REPORT

To the Shareholders and Board of Directors
Pinnacle Bank
Morgan Hill, California

Report on the Financial Statements

We have audited the accompanying financial statements of Pinnacle Bank, which comprise the balance sheets as of December 31, 2018 and 2017, and the related statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pinnacle Bank as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.



Crowe LLP

Sacramento, California
March 28, 2019

PINNACLE BANK
BALANCE SHEETS
December 31, 2018 and 2017

| | <u>2018</u> | <u>2017</u> |
|--|-----------------------|-----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 11,356,196 | \$ 11,478,740 |
| Interest-bearing deposits in other banks | <u>39,380,000</u> | <u>40,755,000</u> |
| Total cash and cash equivalents | 50,736,196 | 52,233,740 |
| Available-for-sale investment securities | 2,447,562 | 2,903,045 |
| Loans, less allowance for loan losses of \$3,718,168 in 2018 and \$3,815,473 in 2017 | 281,917,412 | 265,082,806 |
| Bank premises and equipment, net | 10,463,549 | 9,982,407 |
| Bank owned life insurance | 4,860,621 | 4,743,620 |
| Accrued interest receivable and other assets | <u>9,501,708</u> | <u>7,525,007</u> |
| Total assets | <u>\$ 359,927,048</u> | <u>\$ 342,470,625</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Non-interest bearing | 135,416,964 | 159,796,326 |
| Interest bearing | <u>178,984,292</u> | <u>144,853,801</u> |
| Total deposits | 314,401,256 | 304,650,127 |
| Accrued interest payable and other liabilities | <u>5,286,096</u> | <u>3,585,113</u> |
| Total liabilities | <u>319,687,352</u> | <u>308,235,240</u> |
| Commitments and contingencies (Note 8) | | |
| Shareholders' equity: | | |
| Preferred stock – no par value; 10,000,000 shares authorized, none outstanding | - | - |
| Common stock – no par value; 40,000,000 shares authorized; 4,505,598 shares issued and outstanding in 2018 and 3,959,883 in 2017 | 42,229,700 | 35,478,066 |
| Accumulated deficit | (1,974,862) | (1,236,028) |
| Accumulated other comprehensive loss | <u>(15,142)</u> | <u>(6,653)</u> |
| Total shareholders' equity | <u>40,239,696</u> | <u>34,235,385</u> |
| Total liabilities and shareholders' equity | <u>\$ 359,927,048</u> | <u>\$ 342,470,625</u> |

See accompanying notes to financial statements.

PINNACLE BANK
STATEMENTS OF INCOME
For the Years Ended December 31, 2018 and 2017

| | <u>2018</u> | <u>2017</u> |
|--|---------------------|---------------------|
| Interest income: | | |
| Interest and fees on loans | \$ 16,059,826 | \$ 13,387,059 |
| Interest on interest-bearing deposits in other banks | 1,017,067 | 467,740 |
| Interest on investment securities | 53,129 | 53,487 |
| Other interest income | <u>112,200</u> | <u>79,627</u> |
| Total interest income | <u>17,242,222</u> | <u>13,987,913</u> |
| Interest expense: | | |
| Interest on deposits | 551,793 | 285,403 |
| Interest on short-term borrowings | <u>1</u> | <u>9,900</u> |
| Total interest expense | <u>551,794</u> | <u>295,303</u> |
| Net interest income before provision for loan losses | 16,690,428 | 13,692,610 |
| Provision for loan losses | <u>75,000</u> | <u>537,000</u> |
| Net interest income after provision for loan losses | <u>16,615,428</u> | <u>13,155,610</u> |
| Non-interest income: | | |
| Service charges and fees | 287,076 | 335,492 |
| Loan servicing income, net | 567,028 | 480,211 |
| Gain on sale of loans | 2,012,267 | 2,691,813 |
| Other | <u>397,499</u> | <u>360,861</u> |
| Total non-interest income | <u>3,263,870</u> | <u>3,868,377</u> |
| Non-interest expense: | | |
| Salaries and employee benefits | 8,433,926 | 7,609,607 |
| Occupancy and equipment | 863,018 | 793,185 |
| Other | <u>3,131,755</u> | <u>2,708,744</u> |
| Total non-interest expense | <u>12,428,699</u> | <u>11,111,536</u> |
| Income before income taxes | 7,450,599 | 5,912,451 |
| Income tax expense | <u>2,098,030</u> | <u>2,954,716</u> |
| Net income | <u>\$ 5,352,569</u> | <u>\$ 2,957,735</u> |
| Basic earnings per share | <u>\$ 1.20</u> | <u>\$ 0.68</u> |
| Diluted earnings per share | <u>\$ 1.16</u> | <u>\$ 0.65</u> |

See accompanying notes to financial statements.

PINNACLE BANK
STATEMENTS OF COMPREHENSIVE INCOME
For the Years Ended December 31, 2018 and 2017

| | <u>2018</u> | <u>2017</u> |
|--|---------------------|---------------------|
| Net income | \$ 5,352,569 | \$ 2,957,735 |
| Other comprehensive (loss) income: | | |
| Unrealized (losses) gains on investment securities: | | |
| Unrealized holding (losses) gains arising during the period | (17,088) | (5,822) |
| Less: Reclassification adjustment for realized gains included in net income | _____ - | _____ - |
| | (17,088) | (5,822) |
| Tax effect | <u>8,599</u> | <u>2,929</u> |
| Other comprehensive (loss) income | <u>(8,489)</u> | <u>(2,893)</u> |
| Total comprehensive income | <u>\$ 5,344,080</u> | <u>\$ 2,954,842</u> |

See accompanying notes to financial statements.

PINNACLE BANK
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
For the Years Ended December 31, 2018 and 2017

| | <u>Common Stock</u> | | <u>Accumulated</u> | <u>Accumulated</u> | <u>Shareholders'</u> |
|-----------------------------|---------------------|----------------------|-----------------------|--|----------------------|
| | <u>Shares</u> | <u>Amount</u> | <u>Deficit</u> | <u>Other</u> <u>Compre-</u> <u>hensive</u> <u>Income (loss)</u> | <u>Equity</u> |
| Balance, January 1, 2017 | 3,518,863 | 32,420,260 | (4,193,763) | (3,760) | 28,222,737 |
| Net income | - | - | 2,957,735 | - | 2,957,735 |
| Other comprehensive loss | - | - | - | (2,893) | (2,893) |
| Common stock right offering | 428,945 | 2,895,520 | - | - | 2,895,520 |
| Exercise of stock options | 12,075 | 35,087 | - | - | 35,087 |
| Share-based compensation | <u>-</u> | <u>127,199</u> | <u>-</u> | <u>-</u> | <u>127,199</u> |
| Balance, December 31, 2017 | 3,959,883 | 35,478,066 | (1,236,028) | (6,653) | 34,235,385 |
| Net income | - | - | 5,352,569 | - | 5,352,569 |
| Other comprehensive loss | - | - | - | (8,489) | (8,489) |
| 10% stock dividend | 408,819 | 6,091,403 | (6,091,403) | - | - |
| Exercise of stock options | 136,896 | 429,707 | - | - | 429,707 |
| Share-based compensation | <u>-</u> | <u>230,524</u> | <u>-</u> | <u>-</u> | <u>230,524</u> |
| Balance, December 31, 2018 | <u>4,505,598</u> | <u>\$ 42,229,700</u> | <u>\$ (1,974,862)</u> | <u>\$ (15,142)</u> | <u>\$ 40,239,696</u> |

See accompanying notes to financial statements.

PINNACLE BANK
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2018 and 2017

| | <u>2018</u> | <u>2017</u> |
|---|----------------------|----------------------|
| Cash flows from operating activities: | | |
| Net income | \$ 5,352,569 | \$ 2,957,735 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Gain on sale of loans | (2,012,267) | (2,691,813) |
| Provision for loan losses | 75,000 | 537,000 |
| Depreciation and amortization | 522,263 | 460,258 |
| Decrease (increase) in deferred loan origination costs, net | (80,692) | 94,041 |
| Earnings on Bank owned life insurance | (117,002) | (122,502) |
| Share-based compensation expense | 230,524 | 127,199 |
| Change in deferred tax assets | (458,875) | 1,596,064 |
| Increase (decrease) in accrued interest receivable and other assets | 2,261,178 | (1,550,025) |
| (Decrease) increase in accrued interest payable and other liabilities | <u>1,700,983</u> | <u>(396,424)</u> |
| Net cash provided by operating activities | <u>7,473,681</u> | <u>1,011,533</u> |
| Cash flows from investing activities: | | |
| Increase in loans, net | (18,421,252) | (26,939,910) |
| Purchase of premises and equipment | (987,137) | (4,997,863) |
| Purchase of FHLB stock | (165,800) | (210,000) |
| Maturities and repayments of available-for-sale securities | <u>422,127</u> | <u>561,078</u> |
| Net cash used in investing activities | <u>(19,152,062)</u> | <u>(31,586,695)</u> |
| Cash flows from financing activities: | | |
| Increase (decrease) in demand, interest bearing and savings deposits, net | (2,515,782) | 35,617,137 |
| Increase (decrease) in time deposits, net | 12,266,912 | 5,679,435 |
| Proceeds from common stock rights offering | - | 2,895,520 |
| Proceeds from stock options exercised | <u>429,707</u> | <u>35,087</u> |
| Net cash provided by financing activities | <u>10,180,837</u> | <u>44,227,179</u> |
| Increase (decrease) in cash and cash equivalents | (1,497,544) | 13,652,017 |
| Cash and cash equivalents at beginning of period | <u>52,233,740</u> | <u>38,581,723</u> |
| Cash and cash equivalents at end of period | <u>\$ 50,736,196</u> | <u>\$ 52,233,740</u> |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the year for interest expense | \$ 519,505 | \$ 296,926 |
| Income taxes paid | \$ 1,975,696 | \$ 1,752,085 |

See accompanying notes to financial statements.

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General: Pinnacle Bank ("Bank" or "we" or "our") was approved as a state-chartered non-member bank on July 17, 2006. We are subject to regulation by the California Department of Business Oversight, (the "DBO") and the Federal Deposit Insurance Corporation (the "FDIC"). Our deposits are insured by the FDIC up to applicable legal limits. We are headquartered in Gilroy, California and have offices in Morgan Hill and Salinas. We provide products and services to clients who are predominately small to middle-market businesses, professionals, not-for-profit organizations and individuals located in Santa Clara, San Benito and Monterey counties.

Our accounting and reporting policies conform with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry.

Subsequent Events: We reviewed all events occurring from December 31, 2018 through March 28, 2019, the date the financial statements were available to be issued. In February 2019, we completed an offering of common stock by issuing 698,004 shares at \$11.50 per share for gross proceeds of \$8,027,046.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents: For the purpose of the statement of cash flows, cash and cash equivalents consist of cash and due from banks, and interest-bearing deposits in other banks with original maturities, if any, of three months or less. Net cash flows are reported for client loan and deposit transactions and interest-bearing deposits in other financial institutions.

Investment Securities: Investments are classified into the following categories:

- Available-for-sale investment securities, reported at fair value, with unrealized gains and losses excluded from earnings and reported, net of taxes, as accumulated other comprehensive income (loss) within shareholders' equity.
- Held-to-maturity investment securities, which management has the positive intent and ability to hold to maturity, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums.

Management determines the appropriate classification of its investments at the time of purchase and may only change the classification in certain limited circumstances. All transfers between categories are accounted for at fair value. As of December 31, 2018 and 2017, all of our investments were classified as available-for-sale and there were no transfers between categories during these years.

Gains or losses on the sale of investment securities are computed on the specific identification method. Interest earned on investment securities is reported in interest income, net of applicable adjustments for accretion of discounts and amortization of premiums.

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

FHLB Stock: As a member of the Federal Home Loan System, we are required to maintain an investment in the capital stock of the Federal Home Loan Bank of San Francisco (FHLB). At December 31, 2018 and 2017, our investment of \$1,338,900 and \$1,173,100, respectively, was carried at cost and redeemable at its par value of \$100 per share. FHLB Stock is included in accrued interest receivable and other assets on the balance sheet. The FHLB can suspend dividends and redemptions upon notification to its members.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal amounts outstanding, adjusted for deferred loan origination fees and costs, purchase premiums and discounts, write-downs and the allowance for loan losses. Loan origination fees, net of certain deferred origination costs, and purchase premiums and discounts are recognized as an adjustment to the yield of the related loans, and are reported as a component of net loans.

For all segments of the portfolio, a loan is considered impaired when, based on current information and events, it is probable that all amounts due (including both principal and interest) will not be collected in accordance with the contractual terms of the original loan agreement. An impaired loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical matter, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be repaid solely by the underlying collateral. Interest income on impaired loans, if appropriate, is recognized on a cash basis.

Interest income on loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. A loan is moved to nonaccrual status in accordance with the policy, typically after 90 days of nonpayment.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loan Sales and Servicing: Included in the portfolio are Small Business Administration (SBA) guaranteed loans that may be sold in the secondary market. Loans held for sale are carried at the lower of cost or market value. Market value is determined by the specific identification method as of the balance sheet date or the date that the purchasers have committed to purchase the loans. At the time the loan is sold, the related right to service the loan is recorded at fair value with the Bank earning future servicing income. Gains and losses are calculated based on the difference between the selling price and the fair value of servicing assets or liabilities and the allocated carrying value of the loans sold. At December 31, 2018 and 2017, there were no loans designated as held for sale.

Loans held for sale subsequently transferred to the loan portfolio are transferred at the lower of cost or market value at the date of transfer. Any difference between the carrying amount of the loan and its outstanding principal balance is recognized as an adjustment to yield by the interest method.

Servicing rights acquired through 1) a purchase or 2) the origination of loans which are sold or securitized with servicing rights retained are recognized as separate assets or liabilities. Servicing assets or liabilities are recorded at the difference between the contractual servicing fees and adequate compensation for performing the servicing, and are subsequently amortized in proportion to and over the period of the related net servicing income or expense.

Allowance for Loan Losses: The allowance for loan losses is an estimate of probable credit losses in our loan portfolio that have been incurred as of the balance-sheet date. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to loans individually evaluated for impairment and general reserves for inherent losses related to loans that are collectively evaluated for impairment.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the Bank for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

The determination of the general reserve for loans that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors to include economic trends in the our service areas, industry experience and trends, geographic concentrations, estimated collateral values, our underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

We maintain a separate allowance for each portfolio segment (loan type). These portfolio segments include commercial and industrial, land and construction, commercial real estate and other loans (principally home equity loans). The allowance for loan losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine our overall allowance, which is included on the balance sheet and is available for all loss exposures.

We assign a risk rating to all loans and periodically, but not less than annually, perform detailed loan reviews to identify credit risks, validate risk ratings and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Bank and our regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses may include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss – Loans classified as loss are considered uncollectible and charged off immediately.

The general reserve component of the allowance for loan losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk, (2) historical losses and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

Land and construction – Land and construction loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Commercial real estate – Commercial real estate loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. These loans are generally non-owner occupied properties that generate revenues by leasing the property to others such as commercial buildings of all types and include motels, residential care facilities and self-storage units. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Commercial and industrial – Commercial and industrial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. The commercial and industrial loan portfolio includes borrowers operating in a wide range of activities including manufacturing, services, agri-business and religious organizations. The loans are collateralized by business assets, including receivables, inventory, equipment and real estate. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Other – Other loans consist primarily of home equity lines of credit, short-term single family residential real estate bridge loans, cash secured loans and unsecured loans. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrower's capacity to repay their obligations may be deteriorating.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors and management review the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, our primary regulators, FDIC and DBO, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Allowance for Credit Losses on Off-Balance-Sheet Credit Exposures: We also maintain a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued interest payable and other liabilities on the balance sheet. At December 31, 2018 and 2017, the allowance related to these commitments was not significant.

Other Real Estate: Real estate properties acquired through, or in lieu of, loan foreclosure are expected to be sold and are initially recorded at the fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for loan losses. Subsequent declines in the fair value of other real estate, along with related revenue and expenses from operations, are charged to noninterest expense as incurred.

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Bank Premises and Equipment: Bank premises and equipment are carried at cost, less accumulated depreciation. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets. The useful lives of premises are estimated to be 40 years. The useful lives of furniture, fixtures and equipment are estimated to be 3 to 10 years. Leasehold improvements are generally amortized over the lesser of the respective lease term, including renewal periods that are reasonably assured, or their useful lives.

Certain operating leases contain scheduled and specified rent increases or incentives in the form of tenant improvement allowances or credits. The scheduled rent increases are recognized on a straight-line basis over the lease term. Lease incentives are capitalized at the inception of the lease and amortized on a straight-line basis over the lease term as a reduction of rental expense. Amounts accrued in excess of amounts paid related to the scheduled rent increases and the unamortized deferred credits are included in accrued interest payable and other liabilities on the balance sheet.

When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred. We evaluate premises and equipment for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

Bank Owned Life Insurance: We have purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Income Taxes: Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax basis. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. A valuation allowance is recognized if, based on the weight of available evidence, management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized.

The determination of the amount of deferred income tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed.

Accounting for Uncertainty in Income Taxes: We use a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the statement of income. There have been no significant changes to unrecognized tax benefits or accrued interest and penalties for the years ended December 31, 2018 and 2017.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Earnings Per Share: Basic earnings per share is net income divided by the weighted-average number of common shares outstanding for the period. Diluted earnings per share includes the dilutive effect of additional potential common shares issuable under stock options. The treasury stock method is applied to determine the dilutive effect of stock options in computing diluted earnings per share. Earnings per share are restated for the ten percent stock dividend issued in October 2018.

Share-Based Compensation: The Pinnacle Bank 2016 Equity Incentive Plan (the "Plan"), which was approved by our shareholders and permits the grant of stock options and restricted stock for up to 813,734 shares of our common stock of which 456,174 shares were available for grant as of December 31, 2018. With the adoption of the Plan, no further shares are available for grant under the 2006 Equity Incentive Plan. The Plan is designed to attract and retain employees and directors. The amount, frequency, and terms of share-based awards may vary based on competitive practices, our operating results and government regulations. New shares are issued upon option exercise or grant of restricted stock. The Plan does not provide for the settlement of awards in cash. The Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the exercise price must be paid in full at the time the option is exercised.

Share-based compensation expense is recognized for all stock options that are ultimately expected to vest as the requisite service is rendered, which is generally the vesting period. The fair value of each option award is estimated as of the date of grant using a Black-Scholes-Merton option pricing formula. Expected volatility is based on historical volatility of similar entities over a preceding period commensurate with the expected term of the option when our common stock has been publicly traded for a shorter period than the expected term for the options. The "simplified" method described in SEC Staff Accounting Bulletin No. 110 is used to determine the expected term of our options due to the lack of sufficient historical data. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant with substantially the same term as the expected term of the option. Expected dividend yield is not considered in the option pricing formula since we have not paid dividends and have no current plans to do so in the future. In addition to these assumptions, we make estimates regarding pre-vesting forfeitures that will impact total compensation expense recognized under the Plan.

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

Adoption of New Accounting Standards and Newly Issued Not Yet Effective Accounting Standards: On January 1, 2018, the Bank adopted ASU 2016-01 the new accounting standard for Financial Instruments, which requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The ASU also requires the Bank to use exit price notation when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. The new standard was effective for fiscal years beginning after December 15, 2017, including interim periods with those fiscal years. The impact of adoption of this ASU by the Bank was not material. The fair value disclosures for financial instruments in Note 15 are computed using an exit price notion as required by the ASU.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

On January 1, 2018, the Bank adopted ASU 2014-09 Revenue from Contracts with Customers and all subsequent amendments to the ASU (collectively, “ASC 606”), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. The majority of the Bank’s revenues come from interest income and other sources, including loans, leases, securities and derivatives, which are outside the scope of ASC 606. The Bank’s services that fall within the scope of ASC 606 are presented within Non-Interest Income and are recognized as revenue as the Bank satisfies its obligation to the customer. Services within the scope of ASC 606 include deposit service charges on deposits. Refer to Note 16 Revenue from Contracts with Customers for further discussion on the Bank’s accounting policies for revenue sources within the scope of ASC 606. Adoption of ASC 606 did not have a material impact on the timing or measurement of revenues related to noninterest income.

In February 2018, the FASB issued ASU No. 2018-02, “Income Statement—Reporting Comprehensive Income (Topic 220).” to allow entities a reclassification from other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (“TCJA”). These amendments eliminate the stranded tax effects resulting from the TCJA and will improve the usefulness of information reported to financial statement users. The amendments are effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The adoption of this standard did not have a material effect on the Bank’s operating results or financial condition.

In June 2016, FASB issued guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held to maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. For debt securities with other-than-temporary impairment (OTTI), the guidance will be applied prospectively. Existing purchased credit impaired (PCI) assets will be grandfathered and classified as purchased credit deteriorated (PCD) assets at the date of adoption. The assets will be grossed up for the allowance for expected credit losses for all PCD assets at the date of adoption and will continue to recognize the noncredit discount in interest income based on the yield of such assets as of the adoption date. Subsequent changes in expected credit losses will be recorded through the allowance. For all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective. These amendments are effective for annual periods and interim periods within those annual periods beginning after December 15, 2020. While the Bank is currently evaluating the provisions of this standard to determine the potential impact it will have on the Bank’s financial statements, it has taken steps to prepare for the implementation when it becomes effective, such as forming an internal task force, gathering pertinent data, consulting with outside professionals, and evaluating its current IT systems.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 2 – AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2018 and 2017 consisted of the following:

| | 2018 | | | |
|---|---------------------|------------------------------|-------------------------------|----------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Debt securities: | | | | |
| U.S. Government agencies | \$ 1,000,000 | \$ - | \$ (521) | \$ 999,479 |
| U.S. Government sponsored entities collateralized by residential mortgage obligations | <u>1,477,289</u> | <u>1,255</u> | <u>(30,461)</u> | <u>1,448,083</u> |
| | <u>\$ 2,477,289</u> | <u>\$ 1,255</u> | <u>\$ (30,982)</u> | <u>\$ 2,447,562</u> |

At December 31, 2018, net unrealized losses on available-for-sale investment securities totaling \$29,726 were recorded net of related tax benefits of \$14,584, as accumulated other comprehensive income within shareholders' equity.

| | 2017 | | | |
|---|---------------------|------------------------------|-------------------------------|----------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Debt securities: | | | | |
| U.S. Government agencies | \$ 1,000,000 | \$ - | \$ (3,173) | \$ 996,827 |
| U.S. Government sponsored entities collateralized by residential mortgage obligations | <u>1,915,684</u> | <u>4,111</u> | <u>(13,577)</u> | <u>1,906,218</u> |
| | <u>\$ 2,915,684</u> | <u>\$ 4,111</u> | <u>\$ (16,750)</u> | <u>\$ 2,903,045</u> |

At December 31, 2017, net unrealized losses on available-for-sale investment securities totaling \$12,639 were recorded net of related tax benefits of \$5,986, as accumulated other comprehensive income within shareholders' equity.

There were no sales of investment securities available-for-sale during the years ended December 31, 2018 and 2017. There were no pledged securities as of December 31, 2018 and 2017.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 2 – AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

As of December 31, 2018, \$1,273 in unrealized losses were attributable to two securities that had been in an unrealized loss position for less than 12 months while there were four securities that had been in an unrealized loss position for more than 12 months with unrealized losses totaling \$29,708. As of December 31, 2017, \$4,362 in unrealized losses were attributable to two securities that had been in an unrealized loss position for less than 12 months while there were six securities that had been in an unrealized loss position for more than 12 months with unrealized losses totaling \$12,388. Management believes the unrealized losses on the Bank's investments were caused by interest rate increases. The contractual term of those investments do not permit the issuer to settle the securities at a price less than the amortized costs of the investment. Because it is likely that the Bank will not be required to sell the securities before their anticipated recovery, and the decline in market value is attributable to changes in interest rates and not credit quality, and because the Bank has the ability and intent to hold those investments until a recovery of fair value, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2018 and 2017.

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2018 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Estimated Fair Value |
|--|---------------------|-------------------------|
| Within one year | \$ - | \$ - |
| After one year through five years | 1,000,000 | 999,479 |
| After five years through ten years | - | - |
| After ten years | - | - |
| | 1,000,000 | 999,479 |
| Investment securities not due at a single maturity date: | | |
| U.S. Government sponsored entities collateralized by mortgage obligations | 1,477,289 | 1,448,083 |
| | <u>\$ 2,477,289</u> | <u>\$ 2,447,562</u> |

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES

Outstanding loans at December 31, 2018 and 2017 are summarized below:

| | <u>2018</u> | <u>2017</u> |
|--------------------------------------|-----------------------|-----------------------|
| Commercial and industrial | \$ 164,829,380 | \$ 125,905,819 |
| Commercial real estate | 92,222,131 | 118,176,741 |
| Land and construction | 7,331,965 | 16,169,158 |
| Other | 20,829,637 | 8,304,786 |
| | 285,213,113 | 268,556,504 |
| Deferred loan origination costs, net | 422,467 | 341,775 |
| Allowance for loan losses | (3,718,168) | (3,815,473) |
| | <u>\$ 281,917,412</u> | <u>\$ 265,082,806</u> |

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Salaries and employee benefits totaling \$817,000 and \$978,000 were deferred as loan origination costs for the years ended December 31, 2018 and 2017, respectively.

The following tables show the allocation and activity of the allowance for loan losses at and for the years ended December 31, 2018 and 2017 by portfolio segment and by impairment methodology (amounts in thousands):

| | December 31, 2018 | | | | |
|---|---------------------------------|------------------------------|--------------------------|------------------|-------------------|
| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Other | Total |
| <u>Allowance for Loan Losses</u> | | | | | |
| Beginning balance | \$ 1,957 | \$ 1,445 | \$ 333 | \$ 80 | \$ 3,815 |
| Provision for loan losses | 462 | (344) | (236) | 193 | 75 |
| Loans charged-off | (236) | - | - | - | (236) |
| Recoveries | 51 | 6 | - | 7 | 64 |
| Ending balance allocated to portfolio segments | <u>\$ 2,234</u> | <u>\$ 1,107</u> | <u>\$ 97</u> | <u>\$ 280</u> | <u>\$ 3,718</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 219</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 219</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 2,015</u> | <u>\$ 1,107</u> | <u>\$ 97</u> | <u>\$ 280</u> | <u>\$ 3,499</u> |
| <u>Loans</u> | | | | | |
| Ending balance | <u>\$ 164,829</u> | <u>\$ 92,222</u> | <u>\$ 7,332</u> | <u>\$ 20,830</u> | <u>\$ 285,213</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 352</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 352</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 164,477</u> | <u>\$ 92,222</u> | <u>\$ 7,332</u> | <u>\$ 20,830</u> | <u>\$ 284,861</u> |
| | December 31, 2017 | | | | |
| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Other | Total |
| <u>Allowance for Loan Losses</u> | | | | | |
| Beginning balance | \$ 1,700 | \$ 1,099 | \$ 316 | \$ 71 | \$ 3,186 |
| Provision for loan losses | 175 | 341 | 17 | 4 | 537 |
| Loans charged-off | (125) | - | - | - | (125) |
| Recoveries | 207 | 5 | - | 5 | 217 |
| Ending balance allocated to portfolio segments | <u>\$ 1,957</u> | <u>\$ 1,445</u> | <u>\$ 333</u> | <u>\$ 80</u> | <u>\$ 3,815</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 409</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 409</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 1,548</u> | <u>\$ 1,445</u> | <u>\$ 333</u> | <u>\$ 80</u> | <u>\$ 3,406</u> |
| <u>Loans</u> | | | | | |
| Ending balance | <u>\$ 125,906</u> | <u>\$ 118,177</u> | <u>\$ 16,169</u> | <u>\$ 8,305</u> | <u>\$ 268,557</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 534</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 534</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 120,372</u> | <u>\$ 118,177</u> | <u>\$ 16,169</u> | <u>\$ 8,305</u> | <u>\$ 268,023</u> |

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables show the loan portfolio allocated by management's internal risk ratings at December 31, 2018 and 2017 (amounts in thousands):

| December 31, 2018 | | | | | |
|--|---------------------------|------------------------|-----------------------|------------------|-------------------|
| Commercial Credit Exposure | | | | | |
| Credit Risk Profile by Internally Assigned Grade | | | | | |
| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Other | Total |
| Grade: | | | | | |
| Pass | \$ 163,397 | \$ 91,341 | \$ 7,332 | \$ 20,814 | \$ 282,884 |
| Special Mention | 871 | 881 | - | - | 1,752 |
| Substandard | 561 | - | - | 16 | 577 |
| Doubtful | - | - | - | - | - |
| Total | <u>\$ 164,829</u> | <u>\$ 92,222</u> | <u>\$ 7,332</u> | <u>\$ 20,830</u> | <u>\$ 285,213</u> |

| December 31, 2017 | | | | | |
|--|---------------------------|------------------------|-----------------------|-----------------|-------------------|
| Commercial Credit Exposure | | | | | |
| Credit Risk Profile by Internally Assigned Grade | | | | | |
| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Other | Total |
| Grade: | | | | | |
| Pass | \$ 125,134 | \$ 118,177 | \$ 16,028 | \$ 8,305 | \$ 267,644 |
| Special Mention | 56 | - | 141 | - | 197 |
| Substandard | 716 | - | - | - | 716 |
| Doubtful | - | - | - | - | - |
| Total | <u>\$ 125,906</u> | <u>\$ 118,177</u> | <u>\$ 16,169</u> | <u>\$ 8,305</u> | <u>\$ 268,557</u> |

The following tables show an ageing analysis of the loan portfolio by the time past due at December 31, 2018 and 2017 (amounts in thousands):

| December 31, 2018 | | | | | | |
|---------------------------|---------------------|----------------------------|--------------|----------------|-------------------|-------------------|
| | 30-89 Days Past Due | 90 Days and Still Accruing | Nonaccrual | Total Past Due | Current | Total |
| Commercial and industrial | \$ - | \$ - | \$ 16 | \$ 16 | \$ 164,813 | \$ 164,829 |
| Commercial real estate | - | - | - | - | 92,222 | 92,222 |
| Land and construction | - | - | - | - | 7,332 | 7,332 |
| Other | - | - | - | - | 20,830 | 20,830 |
| Total | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 16</u> | <u>\$ 16</u> | <u>\$ 285,197</u> | <u>\$ 285,213</u> |

| December 31, 2017 | | | | | | |
|---------------------------|---------------------|----------------------------|---------------|----------------|-------------------|-------------------|
| | 30-89 Days Past Due | 90 Days and Still Accruing | Nonaccrual | Total Past Due | Current | Total |
| Commercial and industrial | \$ 45 | \$ - | \$ 284 | \$ 329 | \$ 125,577 | \$ 125,906 |
| Commercial real estate | - | - | - | - | 118,177 | 118,177 |
| Land and construction | - | - | - | - | 16,169 | 16,169 |
| Other | - | - | - | - | 8,305 | 8,305 |
| Total | <u>\$ 45</u> | <u>\$ -</u> | <u>\$ 284</u> | <u>\$ 329</u> | <u>\$ 268,228</u> | <u>\$ 268,557</u> |

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables show information related to impaired loans at and for the years ended December 31, 2018 and 2017 (amounts in thousands):

| | | December 31, 2018 | | | | |
|-------------------------------------|----|--------------------------------|---|------------------------------|--|---|
| | | <u>Recorded Investment</u> | <u>Unpaid Principal Balance</u> | <u>Related Allowance</u> | <u>Average Recorded Investment</u> | <u>Interest Income Recognized</u> |
| With no related allowance recorded: | | | | | | |
| Commercial and industrial | \$ | - | \$ | - | \$ | - |
| Commercial real estate | \$ | - | \$ | - | \$ | - |
| Land and construction | \$ | - | \$ | - | \$ | - |
| Other | \$ | - | \$ | - | \$ | - |
| With an allowance recorded: | | | | | | |
| Commercial and industrial | \$ | 352 | \$ | 352 | \$ | 384 |
| Commercial real estate | \$ | - | \$ | - | \$ | - |
| Land and construction | \$ | - | \$ | - | \$ | - |
| Other | \$ | - | \$ | - | \$ | - |
| Total: | | | | | | |
| Commercial and industrial | \$ | 352 | \$ | 352 | \$ | 384 |
| Commercial real estate | \$ | - | \$ | - | \$ | - |
| Land and construction | \$ | - | \$ | - | \$ | - |
| Other | \$ | - | \$ | - | \$ | - |

| | | December 31, 2017 | | | | |
|-------------------------------------|----|--------------------------------|---|------------------------------|--|---|
| | | <u>Recorded Investment</u> | <u>Unpaid Principal Balance</u> | <u>Related Allowance</u> | <u>Average Recorded Investment</u> | <u>Interest Income Recognized</u> |
| With no related allowance recorded: | | | | | | |
| Commercial and industrial | \$ | - | \$ | - | \$ | - |
| Commercial real estate | \$ | - | \$ | - | \$ | - |
| Land and construction | \$ | - | \$ | - | \$ | - |
| Other | \$ | - | \$ | - | \$ | - |
| With an allowance recorded: | | | | | | |
| Commercial and industrial | \$ | 534 | \$ | 534 | \$ | 544 |
| Commercial real estate | \$ | - | \$ | - | \$ | - |
| Land and construction | \$ | - | \$ | - | \$ | - |
| Other | \$ | - | \$ | - | \$ | - |
| Total: | | | | | | |
| Commercial and industrial | \$ | 534 | \$ | 534 | \$ | 544 |
| Commercial real estate | \$ | - | \$ | - | \$ | - |
| Land and construction | \$ | - | \$ | - | \$ | - |
| Other | \$ | - | \$ | - | \$ | - |

Nonaccrual loans totaled \$16,000 and \$284,000 at December 31, 2018 and 2017, respectively. Interest forgone on nonaccrual loans totaled \$5,000 and \$8,000 for the years ended December 31, 2018 and 2017, respectively. We did not have any accruing loans past due 90 days or more at December 31, 2018 and December 31, 2017.

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

In the table above, the recorded investment in loans excludes accrued interest receivable and loan origination fees as those amounts were not considered significant for disclosure purposes.

We have allocated \$219,000 of specific reserves to clients whose loan terms have been modified in troubled debt restructurings as of December 31, 2018. We have allocated \$234,000 of specific reserves to clients whose loan terms have been modified in troubled debt restructurings as of December 31, 2017. We do not have commitments to lend additional funds to borrowers with loans whose terms have been modified in troubled debt restructurings.

During the year ended December 31, 2018, there was two loans modified as troubled debt restructuring (TDR) with a recorded investment of \$237,000 and no defaults of TDRs within twelve months of their modification. During the year ended December 31, 2017, there was one loan modified as troubled debt restructuring (TDR) with a recorded investment of \$248,000 and three defaults of TDRs within twelve months of their modification. These troubled debt restructurings did not result in any charge offs and did not increase the allowance for loan losses. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under our internal underwriting policy.

The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from seven months to two years. Modifications involving an extension of the maturity date were for periods up to ten years.

A restructured loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

NOTE 4 – BANK PREMISES AND EQUIPMENT

Bank premises and equipment at December 31, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|--|----------------------|---------------------|
| Premises | \$ 8,489,710 | \$ 8,505,088 |
| Furniture, fixtures and equipment | 1,759,074 | 1,359,318 |
| Leasehold improvements | <u>3,690,684</u> | <u>3,088,259</u> |
| | 13,939,468 | 12,952,665 |
| Less accumulated depreciation and amortization | <u>(3,475,919)</u> | <u>(2,970,258)</u> |
| | <u>\$ 10,463,549</u> | <u>\$ 9,982,407</u> |

Depreciation and amortization included in occupancy and equipment expense totaled \$506,000 and \$436,000 for the years ended December 31, 2018 and 2017, respectively.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 5 – LOAN SERVICING

SBA loans and USDA loans with unpaid balances of approximately \$176,567,000 and \$136,334,000 were being serviced for others at December 31, 2018 and 2017, respectively. Servicing assets are periodically evaluated for impairment. Servicing assets at December 31, 2018 and 2017 were \$4,464,671 and \$3,689,217, respectively and are included in accrued interest receivable and other assets on the balance sheet. The estimated fair value of these servicing rights was in excess of their carrying value at December 31, 2018 and 2017, and therefore no valuation allowance was necessary. Activity for loan servicing assets consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|----------------------|---------------------|---------------------|
| Beginning of year | \$ 3,689,217 | \$ 2,025,076 |
| Additions | 1,592,534 | 2,317,343 |
| Disposals | (147,293) | (181,006) |
| Amortized to expense | <u>(669,787)</u> | <u>(472,196)</u> |
| End of year | <u>\$ 4,464,671</u> | <u>\$ 3,689,217</u> |

NOTE 6 – INTEREST-BEARING DEPOSITS

Interest-bearing deposits at December 31, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|----------------------------------|-----------------------|-----------------------|
| Savings | \$ 21,194,215 | \$ 20,050,274 |
| Money market | 89,515,704 | 72,283,409 |
| Interest-bearing demand accounts | 22,324,629 | 18,837,286 |
| Time, \$250,000 or more | 17,633,853 | 8,612,607 |
| Other time | <u>28,315,891</u> | <u>25,070,225</u> |
| | <u>\$ 178,984,292</u> | <u>\$ 144,853,801</u> |

Aggregate annual maturities of time deposits are as follows:

| <u>Year Ending</u> <u>December 31,</u> | |
|---|----------------------|
| 2019 | \$ 36,218,968 |
| 2020 | 7,391,219 |
| 2021 | 2,339,557 |
| 2022 | - |
| 2023 | <u>-</u> |
| | <u>\$ 45,949,744</u> |

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 6 – INTEREST-BEARING DEPOSITS (Continued)

Interest expense recognized on interest-bearing deposits for the years ended December 31, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|----------------------------------|-------------------|-------------------|
| Savings | \$ 31,041 | \$ 25,048 |
| Money market | 204,566 | 133,015 |
| Interest-bearing demand accounts | 27,431 | 22,103 |
| Time, \$250,000 or more | 130,633 | 43,476 |
| Other time | <u>158,122</u> | <u>61,761</u> |
| | <u>\$ 551,793</u> | <u>\$ 285,403</u> |

NOTE 7 – INCOME TAXES

Income taxes for the years ended December 31, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|--------------------|---------------------|---------------------|
| Current | \$ 2,556,905 | \$ 1,358,652 |
| Deferred | <u>(458,875)</u> | <u>1,596,064</u> |
| Income tax expense | <u>\$ 2,098,030</u> | <u>\$ 2,954,716</u> |

Our effective tax rate differs from the statutory rate primarily as a result of stock option compensation expense related to incentive stock options, and non-taxable income from Bank owned life insurance and deferred tax asset re-measurement.

The total amount of unrecognized tax benefits, including interest and penalties, at December 31, 2018 and 2017 was not considered significant. The amount of tax benefits that would impact the effective rate, if recognized, is not expected to be material. We do not anticipate any significant changes with respect to unrecognized tax benefits within the next 12 months.

Deferred tax assets and liabilities at December 31, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|-----------------------------------|------------------|------------------|
| Deferred tax assets: | | |
| State deferred tax asset | \$ 713,384 | \$ 476,575 |
| Organization costs | 50,228 | 69,989 |
| Share-based compensation expense | 198,179 | 219,464 |
| Allowance for loan losses | 331,879 | 316,129 |
| Other accruals | 959,196 | 707,003 |
| Unrealized loss on AFS securities | <u>8,788</u> | <u>4,343</u> |
| Total deferred tax assets | <u>2,261,654</u> | <u>1,793,503</u> |

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 7 – INCOME TAXES (Continued)

| | <u>2018</u> | <u>2017</u> |
|--------------------------------|---------------------|---------------------|
| Deferred tax liabilities: | | |
| Deferred loan costs | (260,406) | (265,911) |
| Bank premises and equipment | (142,546) | (116,970) |
| Other liabilities | <u>(28,492)</u> | <u>(43,774)</u> |
| Total deferred tax liabilities | <u>(431,444)</u> | <u>(426,655)</u> |
| Net deferred tax assets | <u>\$ 1,830,210</u> | <u>\$ 1,366,848</u> |

Management believes that it is more likely than not that it will realize the above deferred tax assets in future periods; therefore, no valuation allowance has been provided against its deferred tax assets.

At December 31, 2018, the Bank had no federal or California net operating loss carryforwards.

The Bank files income tax returns in the U.S. Federal and California jurisdictions. There are currently no pending U.S. Federal or State income tax or non-U.S. income tax examinations by tax authorities. With few exceptions, the Bank is no longer subject to tax examinations by U.S. Federal taxing authorities for years ended before December 31, 2014 and by state and local taxing authorities for years ended before December 31, 2013.

On December 22, 2017, H.R.1, commonly known as the Tax Cuts and Jobs Act (the “Tax Act”), was signed into law, which among other items reduces the federal corporate tax rate to 21% from 34%, effective January 1, 2018. U.S. generally accepted accounting principles requires companies to revalue certain tax related assets as of the date of enactment of the new legislation with resulting tax effects accounted for in the reporting period of enactment. As a result, we performed an analysis to determine the impact of the revaluation of the net deferred tax asset. The value of the deferred tax asset was reduced by \$517,695 and recorded as tax expense for the year ended December 31, 2017.

NOTE 8 – SHORT-TERM BORROWING ARRANGEMENTS

The Bank has unsecured lines of credit with two correspondent banks in the amount of \$5,000,000 at December 31, 2018 and 2017. There were no borrowings outstanding under these borrowing arrangement as of December 31, 2018 and 2017.

We have secured lines of credit at the Federal Home Loan Bank of San Francisco and the Federal Reserve Bank of San Francisco under which we can borrow up to approximately \$65,620,000 on either a short-term or long-term basis. These secured lines of credit are based on pledged loans with carrying values of approximately \$93,685,000 and \$108,622,000 at December 31, 2018 and 2017, respectively. There were no borrowings outstanding under these arrangements at December 31, 2018 and 2017.

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Correspondent Banking Agreements: We maintain funds on deposit with other federally insured financial institutions under correspondent banking agreements. While these funds are insured up to the applicable legal limits of \$250,000 per institution, the funds on deposit with these institutions may exceed those insured limits. As of December 31, 2018 and 2017, funds maintained with these institutions, in excess of federally insured limits totaled \$6,241,000 and \$6,938,000, respectively.

Operating Leases: The Bank purchased its leased Salinas office in 2017 and has no other leased facilities. Rental expense included in occupancy and equipment expense totaled \$41,000 for the year ended December 31, 2017.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

Financial Instruments With Off-Balance-Sheet Risk: We are a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of our clients and to reduce our own exposure to fluctuations in interest rates. These financial instruments consist of commitments to extend credit of \$60,774,000 and \$70,058,000 at December 31, 2018 and 2017, respectively.

Our exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit is represented by the contractual amount of those instruments. We use the same credit policies in making commitments as we use for loans included on the balance sheet.

Commitments to extend credit are agreements to lend to a client as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but may include accounts receivable, inventory, and deeds of trust on residential real estate and income-producing commercial properties.

At December 31, 2018, commercial and industrial loan commitments represent approximately 58% of total commitments and are generally unsecured or secured by collateral comprised of business assets or real estate and have variable interest rates. Commercial real estate loan commitments represent approximately 32% of total commitments and are generally secured by property with a loan-to-value ratio not to exceed 70%. The majority of real estate commitments also have variable interest rates. Land and construction loan commitments represent 3% of total commitments and are secured by land and construction projects and have variable interest rates. Home equity lines of credit and other loans represent the remaining 7% of total commitments and are generally secured by residential real estate and have both variable and fixed interest rates.

Concentrations of Credit Risk: We grant commercial real estate, land and construction and commercial and industrial loans to clients in Santa Clara, San Benito, Monterey and surrounding counties. Although we intend to have a diversified loan portfolio, a substantial portion of the portfolio is secured by non-owner occupied real estate.

At December 31, 2018, in management's judgment, a concentration existed in non-owner occupied real estate loans. At that date, approximately 32% of total loans were non-owner occupied real estate related, with commercial real estate collateral representing 22% and residential real estate collateral representing 10% of total loans.

At December 31, 2017, in management's judgment, a concentration existed in non-owner occupied real estate loans. At that date, approximately 44% of total loans were non-owner occupied real estate related, with commercial real estate collateral representing 40% and residential real estate collateral representing 4% of total loans.

Although management of the Bank believes the collectability of loans within this concentration has been appropriately considered in adequacy of the allowance for loan losses, a continued substantial decline in the performance of the economy in general or a continued decline in real estate values in our primary market area, in particular, could have an adverse impact on collectability, increase the level of real estate related nonperforming loans, or have other adverse effects which alone or in the aggregate could have a material adverse effect on our financial condition. Business income represents the primary source of repayment for a majority of these loans.

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

Concentrations in Deposit and Loan Relationships: At December 31, 2018, there were no clients with deposits that exceeded 5% of total deposits. At December 31, 2017, there was one client with deposits of \$16.0 million that exceeded 5% of total deposits. As of December 31, 2018 and 2017, there were no borrowers whose individual loans exceeded 10% of total loans.

Contingencies: We may be subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect our financial position or results of operations.

NOTE 10 – SHARE-BASED PAYMENTS

The Pinnacle Bank 2016 Equity Incentive Plan (the "Plan") permits the grant of stock options to directors, organizers and employees of the Bank as well as restricted stock awards to directors and employees. There have been no awards of restricted stock under this plan. Option grants to directors and employees are either non-qualified or incentive stock option awards. All of the options granted under the Plan and the 2006 Equity Incentive Plan have a 10 year term and have been issued with exercise prices at the fair market value of the underlying shares at the date of grant. The stock option awards to directors and employees stock option awards vest over a three to five year period from the date the options were granted.

A summary of the outstanding and vested stock option activity for the years ended December 31, 2018 and 2017 is as follows:

| | Outstanding | | Nonvested | |
|------------------------------|-------------|---|-----------|--|
| | Shares | Weighted Average Exercise Price Per Share | Shares | Weighted Average Fair Value Per Share |
| Balance, January 1, 2017 | 222,944 | \$ 3.07 | 19,261 | \$ 3.28 |
| Options granted | 175,230 | \$ 7.01 | 175,230 | \$ 2.72 |
| Options vested | - | \$ - | (6,941) | \$ 2.95 |
| Options expired or cancelled | (13,283) | \$ 2.46 | - | \$ - |
| Options exercised | (12,922) | \$ 4.68 | - | \$ - |
| Balance, December 31, 2017 | 371,969 | \$ 4.97 | 187,550 | \$ 2.77 |
| Options granted | 182,110 | \$ 10.98 | 182,110 | \$ 1.25 |
| Options vested | - | \$ - | (49,232) | \$ 2.73 |
| Options expired or cancelled | (4,187) | \$ 5.05 | (4,177) | \$ 2.44 |
| Options exercised | (149,763) | \$ 2.84 | - | \$ - |
| Balance, December 31, 2018 | 400,129 | \$ 8.49 | 316,251 | \$ 2.36 |

(Continued)

PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 10 – SHARE-BASED PAYMENTS (Continued)

A summary of exercisable stock options as of December 31, 2018 is as follows:

| | |
|--|-------------|
| Number of vested stock options | 83,877 |
| Number of options vested or expected to vest | 384,316 |
| Weighted average exercise price per share | \$5.46 |
| Aggregate intrinsic value | \$1,064,373 |
| Weighted average remaining contractual term in years | 5.74 |

A summary of options outstanding at December 31, 2018 follows:

| <u>Range of Exercise Prices</u> | <u>Number of Options Outstanding December 31, 2018</u> | <u>Weighted Average Remaining Contractual Term</u> | <u>Number of Options Exercisable December 31, 2018</u> |
|---------------------------------|--|--|--|
| \$2.46 - \$5.99 | 33,438 | 1.18 years | 33,306 |
| \$6.00 - \$9.99 | 184,031 | 7.97 years | 50,462 |
| \$10.00 - \$13.25 | <u>182,660</u> | 4.31 years | <u>110</u> |
| | <u>400,129</u> | 5.74 years | <u>83,878</u> |

The following table describes the significant assumptions used during 2018 and 2017 to estimate the fair value of stock options granted:

| | <u>2018</u> | <u>2017</u> |
|--|----------------|----------------|
| Dividend yield | - | - |
| Expected volatility | 17.5% to 34.4% | 32.1% to 36.8% |
| Risk-free interest rate | 2.25% to 2.92% | 1.99% to 2.36% |
| Expected option life in years | 3.5 to 6.5 | 6 to 6.5 |
| Weighted average fair value of options granted during the year | \$1.25 | \$7.72 |

The following table summarizes stock option information as of and for the years ended December 31, 2018 and 2017:

| | <u>2018</u> | <u>2017</u> |
|--|--------------|-------------|
| Total intrinsic value of options exercised | \$ 1,357,654 | \$ 76,600 |
| Aggregate cash received for option exercises | \$ 429,708 | \$ 35,087 |
| Total compensation cost recognized | \$ 230,524 | \$ 127,197 |
| Tax benefit recognized | \$ - | \$ - |
| Total compensation cost for nonvested awards not yet recognized | \$ 474,563 | \$ 374,231 |
| Weighted average years for compensation expense to be recognized | 1.99 | 2.34 |

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 11 – SHAREHOLDERS' EQUITY

Dividends: Upon declaration by the Board of Directors, all shareholders of record will be entitled to receive dividends. The California Financial Code restricts the total dividend payment of any state banking association in any calendar year to the lesser of (1) the bank's retained earnings or (2) the bank's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period. At December 31, 2018, no amounts were free of such restrictions.

Earnings Per Share: A reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the years ended December 31, 2018 and 2017 is shown below.

| | <u>Net Income</u> | <u>Weighted Average Number of Shares Outstanding</u> | <u>Per Share Amount</u> |
|----------------------------------|-----------------------|--|-----------------------------|
| <u>December 31, 2018</u> | | | |
| Basic earnings per share | \$ 5,352,569 | 4,474,374 | \$ <u>1.20</u> |
| Effect of dilutive stock options | <u>-</u> | <u>144,633</u> | |
| Diluted earnings per share | <u>\$ 5,532,569</u> | <u>4,619,007</u> | <u>\$ 1.16</u> |
| <u>December 31, 2017</u> | | | |
| Basic earnings per share | \$ 2,957,735 | 3,917,169 | \$ <u>0.76</u> |
| Effect of dilutive stock options | <u>-</u> | <u>144,543</u> | |
| Diluted earnings per share | <u>\$ 2,957,735</u> | <u>4,061,712</u> | <u>\$ 0.73</u> |

Regulatory Capital: We are subject to certain regulatory capital requirements administered by the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The final rules implementing Basel committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based ratios. The capital conservation buffer is being phased in from 0.625% in 2016 to 2.50% by 2019. The capital conservation buffer for 2018 was 1.875% and 2017 was 1.25%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2018, the Bank meets all capital adequacy requirements to which it is subject.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 11 – SHAREHOLDERS' EQUITY (Continued)

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. As of December 31, 2018 and 2017, the most recent regulatory notifications categorized the Bank as "well capitalized" under the regulatory framework for prompt correction action. There are no conditions or events since the most recent notification that management believes have changed the Bank's category. The following table excludes the capital conservation buffer.

| | 2017 | | 2016 | |
|--|---------------|--------------|---------------|--------------|
| | <u>Amount</u> | <u>Ratio</u> | <u>Amount</u> | <u>Ratio</u> |
| <u>Tier 1 Leverage Ratio</u> | | | | |
| Pinnacle Bank | \$ 40,229 | 10.7% | \$ 34,193 | 9.5% |
| Minimum requirement for "Well-Capitalized" institution | \$ 18,731 | 5.0% | \$ 18,002 | 5.0% |
| Minimum regulatory requirement | \$ 14,984 | 4.0% | \$ 14,401 | 4.0% |
| <u>Common Equity Tier 1 Capital Ratio</u> | | | | |
| Pinnacle Bank | \$ 40,229 | 12.4% | 34,193 | 10.8% |
| Minimum requirement for "Well-Capitalized" institution | \$ 21,133 | 6.5% | 20,606 | 6.5% |
| Minimum regulatory requirement | \$ 14,631 | 4.5% | 14,266 | 4.5% |
| <u>Tier 1 Capital Ratio</u> | | | | |
| Pinnacle Bank | \$ 40,229 | 12.4% | \$ 34,193 | 10.8% |
| Minimum requirement for "Well-Capitalized" institution | \$ 26,010 | 8.0% | \$ 25,361 | 8.0% |
| Minimum regulatory requirement | \$ 19,508 | 6.0% | \$ 19,021 | 6.0% |
| <u>Total Capital Ratio</u> | | | | |
| Pinnacle Bank | \$ 43,971 | 13.5% | \$ 38,026 | 12.0% |
| Minimum requirement for "Well-Capitalized" institution | \$ 32,513 | 10.0% | \$ 31,701 | 10.0% |
| Minimum regulatory requirement | \$ 26,010 | 8.0% | \$ 25,361 | 8.0% |

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 12 – RELATED PARTY TRANSACTIONS

During the normal course of business, we enter into transactions with related parties, including directors, and executive officers. The following is a summary of the aggregate activity involving related party borrowers during the year ended December 31, 2018:

| | |
|--|---------------------|
| Balance, January 1, 2018 | \$ 3,626,224 |
| Disbursements | 719,828 |
| Amounts repaid | <u>(931,357)</u> |
| Balance, December 31, 2018 | <u>\$ 3,414,695</u> |
| Undisbursed commitments to related parties, December 31, 2018 | <u>\$ 3,177,130</u> |

At December 31, 2018 and 2017, our deposits from related parties totaled \$10,174,000 and \$6,294,000, respectively.

NOTE 13 – EMPLOYEE BENEFIT PLANS

401(k) Plan: In 2006, we adopted the Pinnacle Bank 401(k) Profit Sharing Plan and Trust effective January 1, 2007. All employees 21 years of age or older are eligible to participate in the plan. Eligible employees may elect to make tax deferred contributions up to the maximum amount allowed by law. We may make additional contributions to the plan at the discretion of the Board of Directors. During the years ended December 31, 2018 and 2017, we contributed \$107,000 and \$88,000 to the Plan on behalf of our employees.

Supplemental Executive Retirement Plan: Effective in 2014, the Bank adopted a Supplemental Executive Retirement Plan (SERP) for five executives (participants). The Bank will annually contribute to the SERP a total of ten percent of income before income tax which is then allocated to the participants' accounts up to age 65. Interest accrues on the participants' account balances based on the Citigroup Pension Liability Index adjusted annually as of the last business day in the prior calendar year (4.22% at December 31, 2018). Participants will receive 240 monthly payments from their accumulated balances following separation of service after reaching age 62 with seven years of service or after 15 years of service. As of and for the year ended December 31, 2018 and 2017, the Bank had accrued liabilities of \$2,439,000 and \$1,546,000, respectively and incurred expenses of \$828,000 and \$657,000, respectively. There were no payments to participants made under the SERP during the year ended 2018. Payments to participants will not begin until after separation from service.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 14 – OTHER EXPENSES

Other expenses for the years ended December 31, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|--------------------------------------|---------------------|---------------------|
| Data processing | \$ 765,634 | \$ 659,895 |
| Professional fees | 487,993 | 414,935 |
| Advertising and marketing | 377,276 | 331,349 |
| Software licenses | 242,912 | 188,492 |
| Regulatory assessments | 206,012 | 238,855 |
| Director fees | 190,000 | 143,000 |
| Share-based compensation – directors | 116,447 | 62,041 |
| Business development | 111,423 | 106,772 |
| Telephone | 104,711 | 114,111 |
| Subscription services | 61,129 | 49,668 |
| Stationery and supplies | 51,702 | 45,716 |
| Insurance | 36,866 | 36,570 |
| Other | <u>379,650</u> | <u>317,340</u> |
| | <u>\$ 3,131,755</u> | <u>\$ 2,708,744</u> |

NOTE 15 – FAIR VALUE MEASUREMENTS

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 –Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 – Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 15 – FAIR VALUE MEASUREMENTS (Continued)

Assets Recorded at Fair Value – The following tables present information about our assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2018 and 2017:

Recurring Basis

| <u>Description</u> | <u>December 31, 2018</u> | | | |
|---|--------------------------|----------------|---------------------|----------------|
| | <u>Fair Value</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> |
| Debt securities: | | | | |
| U.S. Government agencies | \$ 999,479 | \$ - | \$ 999,479 | \$ - |
| U.S. Government sponsored entities collateralized by residential mortgage obligations | <u>1,448,083</u> | <u>-</u> | <u>1,448,083</u> | <u>-</u> |
| Total assets measured at fair value | <u>\$ 2,447,562</u> | <u>\$ -</u> | <u>\$ 2,447,562</u> | <u>\$ -</u> |

| <u>Description</u> | <u>December 31, 2017</u> | | | |
|---|--------------------------|----------------|---------------------|----------------|
| | <u>Fair Value</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> |
| Debt securities: | | | | |
| U.S. Government agencies | \$ 996,827 | \$ - | \$ 996,827 | \$ - |
| U.S. Government sponsored entities collateralized by residential mortgage obligations | <u>1,906,218</u> | <u>-</u> | <u>1,906,218</u> | <u>-</u> |
| Total assets measured at fair value | <u>\$ 2,903,045</u> | <u>\$ -</u> | <u>\$ 2,903,045</u> | <u>\$ -</u> |

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the years ended December 31, 2018 and 2017, there were no transfers in or out of Levels 1 and 2.

Non-recurring Basis

We may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value which was below cost at the reporting date.

There were no assets that were measured at fair value on a non-recurring basis as of December 31, 2018 and 2017.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 15 – FAIR VALUE MEASUREMENTS (Continued)

Fair Value of Financial Instruments: The carrying amount and estimated fair values of the Bank's financial instruments are as follows:

| <u>December 31, 2018</u> | <u>Carrying Amount</u> | <u>Fair Value Measurements at Using:</u> | | | |
|-------------------------------|------------------------|--|----------------|----------------|----------------|
| | | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 50,736,196 | \$ 50,736,196 | \$ - | \$ - | \$ 50,736,196 |
| Available-for-sale securities | 2,447,562 | - | 2,447,562 | - | 2,447,562 |
| Loans, gross | 285,213,113 | - | - | 284,399,978 | 284,399,978 |
| FHLB stock | 1,338,900 | NA | NA | NA | 1,338,900 |
| Accrued interest receivable | 1,062,536 | 1,062,536 | - | - | 1,062,536 |
| Financial liabilities: | | | | | |
| Deposits | \$ 314,401,256 | \$ 268,451,512 | \$ - | \$45,827,660 | \$ 314,279,172 |
| Accrued interest payable | 42,561 | 42,561 | - | - | 42,561 |

| <u>December 31, 2017</u> | <u>Carrying Amount</u> | <u>Fair Value Measurements at Using:</u> | | | |
|-------------------------------|------------------------|--|----------------|----------------|----------------|
| | | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 52,233,740 | \$ 52,233,740 | \$ - | \$ - | \$ 52,233,740 |
| Available-for-sale securities | 2,903,045 | - | 2,903,045 | - | 2,903,045 |
| Loans, gross | 268,556,504 | - | - | 268,150,124 | 268,150,124 |
| FHLB stock | 1,173,100 | NA | NA | NA | 1,173,100 |
| Accrued interest receivable | 845,440 | 845,440 | - | - | 845,440 |
| Financial liabilities: | | | | | |
| Deposits | \$ 304,650,127 | \$ 270,967,295 | \$ 33,606,661 | \$ - | \$ 304,573,956 |
| Accrued interest payable | 10,271 | 10,271 | - | - | 10,271 |

These estimates do not reflect any premium or discount that could result from offering the Bank's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

The following methods and assumptions were used by the Bank to estimate the fair values of its financial instruments at December 31, 2018 and December 31, 2017:

Cash and cash equivalents: The carrying amounts of cash and short-term instruments approximate fair values and are classified as Level 1.

Investment securities: For investment securities, fair values are estimated using quoted market prices for similar securities and model-based valuation techniques for which all significant assumptions are observable and are classified as Level 2 classification.

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PINNACLE BANK
NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2018 and 2017

NOTE 15 – FAIR VALUE MEASUREMENTS (Continued)

Loans and leases: For 2018, the fair value of loans is estimated on an exit price basis incorporating contractual cash flow, prepayments discount spreads, credit loss and liquidity premiums. For 2017, the fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Loans with similar characteristics are aggregated for purposes of the calculations.

FHLB stock: It is not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Deposits: The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amount) resulting in a Level 1 classification. Fair values for fixed rate time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Accrued interest receivable and payable: The carrying amount of accrued interest receivable and payable approximates fair value resulting in a Level 1 classification.

The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements and are not significant and, therefore, not included in the above table.

NOTE 16 – REVENUE FROM CONTRACTS WITH CLIENTS

All of the Bank's revenue from contracts with clients in the scope of ASC 606 is recognized within Non-Interest Income. The sources of Non-Interest Income subject to ASC 606 were service charges on deposit accounts of \$287,076 and \$335,492 for the years ended December 31, 2018 and 2017, respectively, and other fees of \$280,496 and \$238,359 for the years ended December 31, 2018 and 2017, respectively,.

Service charges on deposit accounts represent fees earned from deposit clients for commercial account and insufficient funds services. Commercial account fees, which include the processing of deposits, payment of checks, wire transfers and electronic transfers and statement rendering, are recognized at both the time the transaction is executed and at the end of the month in which the services are performed. Insufficient funds fees are recognized at the point in time that the insufficient item is processed. Service charges on deposits are withdrawn from the client's account balance.

Other fees are earned when our clients use merchant services and ATM and electronic funds networks. These fees are received from third-parties.